

REPORT BY THE  
AUDITOR GENERAL  
OF CALIFORNIA

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THE DEPARTMENTS WE REVIEWED WITHIN  
THE HEALTH AND WELFARE AGENCY  
ARE NOT COMPLYING WITH THE  
DIRECT SERVICE CONTRACT REFORMS

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REPORT BY THE  
OFFICE OF THE AUDITOR GENERAL

F-859

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THE HEALTH AND WELFARE AGENCY  
ARE NOT COMPLYING WITH THE  
DIRECT SERVICE CONTRACT REFORMS

JULY 1989



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Kurt R. Sjoberg  
Acting Auditor General

July 6, 1989

F-859

Honorable Elihu M. Harris, Chairman  
Members, Joint Legislative  
Audit Committee  
State Capitol, Room 2148  
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning direct service contracts between three departments within the Health and Welfare Agency and nonprofit organizations. We found that the three departments have done little to comply with the direct service contract reforms.

We conducted this audit to comply with Chapter 891, Statutes of 1988.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Kurt Sjoberg".

KURT R. SJÖBERG  
Acting Auditor General

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## SUMMARY

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### RESULTS IN BRIEF

From 1980 through 1982, the Legislature enacted direct service contract reforms for the departments within the Health and Welfare Agency (agency) to follow in their award of direct service contracts to nonprofit organizations and their administration of those contracts. The Department of Aging, the Department of Health Services, and the Department of Social Services had the greatest number of direct service contracts with nonprofit organizations in fiscal year 1987-88, so we reviewed their compliance with the direct service contract reforms. During our review of direct service contracts with nonprofit organizations for fiscal year 1985-86 through fiscal year 1987-88 at these three departments, we found that the departments have done little to comply with the direct service contract reforms. Specifically, we found the following conditions:

- The departments are not identifying the programs for which they award direct service contracts;
- The departments are not following all of the procedures required for bidding and awarding direct service contracts;
- The departments are not ensuring that nonprofit organizations to which they award direct service contracts have independent financial and compliance audits; and
- The departments are not meeting the goal of resolving disputes with nonprofit organizations within 60 days.

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### BACKGROUND

Ten of the 11 departments within the agency entered into direct service contracts with nonprofit organizations in fiscal year

1987-88. Under a direct service contract, the department either provides a service to or receives a service from a contractor in a local assistance or subvention program. From 1980 through 1982, the Legislature enacted statutes that constitute the Direct Service Contracts Reform Act (reform act). Before this reform act, there were no specific statutory requirements for direct service contracts. Lacking these references, the departments and nonprofit organizations could not be certain as to the state requirements for bidding and awarding direct service contracts. Also, the departments lacked information on managing and evaluating these contracts. The purpose of the reform act is to ensure that, before awarding direct service contracts to nonprofit organizations, the departments within the agency provide these organizations with the appropriate information to enable them to faithfully execute the contracts and meet the audit standards that are established by agency departments.

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## **PRINCIPAL FINDINGS**

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### **Departments Are Not Identifying the Programs for Which Direct Service Contracts Are Awarded**

The reform act requires departments of the agency to identify programs for which they have awarded more than five direct service contracts totaling over \$250,000 per year. However, the three departments we reviewed do not identify these programs. Because the direct service contract reforms require specific controls for these programs, if the departments do not identify the programs, the departments may not establish all the required controls over direct service contracts.

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### Departments Are Not Complying With Contract Bidding and Awarding Procedures

The reform act requires the departments within the agency to perform certain procedures during the bidding and awarding process for direct service contracts. However, the three departments we reviewed are not always complying with these procedures. Specifically, the Department of Aging is not identifying all the target dates in the process, as required. Also, none of the three departments we reviewed include all the required information in their distribution lists, nor do they include all the required elements in their requests for proposal. When the departments do not follow these procedures, nonprofit organizations may not be aware of all the funding opportunities available through direct service contracts, all the requirements they must satisfy to submit successful bids, or the basis on which their bid or contract performance will be evaluated.

In addition to the procedures, the reform act requires the Department of General Services' review and approval of contracts for services unless the contract is exempt by a specific statute or provision. We found that the Department of Aging and the Department of Health Services do not always obtain the Department of General Services' approval when it is necessary.

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### Departments Are Not Ensuring That Required Audits Are Performed

The reform act requires an independent financial and compliance audit of all nonprofit organizations that enter into direct service contracts. Since the nonprofit organizations are required to have the audits, we believe the departments are responsible for determining whether they comply with this requirement. The three departments we reviewed did not always evaluate whether the nonprofit organizations are complying with the audit requirements. For example, for the 80 nonprofit organizations we

reviewed at the Department of Aging, there were 147 audits required during the three fiscal years of our review. We found that the department had confirmed that 71 of the 147 audits were performed. We confirmed that at least an additional 47 of the audits were performed, but at least 11 of the audits had not been performed.

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#### Departments Are Not Meeting the Goal of Resolving Disputes Within 60 Days

The three departments we reviewed are not resolving, within the goal of 60 days, disputes with nonprofit organizations that contract with the State through direct service contracts. In fact, at the Department of Aging and the Department of Health Services, the disputing parties are taking between 70 and 347 days to resolve their disputes. At the Department of Social Services, the disputing parties have not resolved two disputes that we reviewed even though 1,456 and 1,509 days have passed since the receipt of the complaint. This may result in the direct service contractors continuing to violate the contract provisions. Also, when disputes are not resolved promptly, the direct service contractors and the departments may incur increased costs while attempting to resolve the audit findings.

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#### RECOMMENDATIONS

The agency should inform its departments of the requirements of the reform act. It should then ensure that all of its departments are complying with the reform act. Specifically, the agency should ensure that its departments do the following:

- Identify the programs for which they award more than five direct service contracts totaling over \$250,000 per year;
- Follow all procedures required during the bidding and awarding process for direct service contracts;

- Ensure that the required financial and compliance audits of the direct service contractors are conducted; and
- Resolve disputes with nonprofit organizations within 60 days.

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#### AGENCY COMMENTS

The Department of Aging responded that it did not consider any of its contracts to be direct service contracts based on its interpretation of an attorney general's opinion. If its contracts are direct service contracts, as suggested in the legislative counsel's opinion in the appendix, the Department of Aging assured us that it will implement any needed procedures or actions to comply with the reform act.

The Department of Health Services responded that it disagreed with our overall finding that it has done little to comply with the reform act. The Department of Health Services indicated that it has taken some steps to comply with the reform act and will take additional steps to ensure compliance. The Department of Health Services also had three areas of concern with our report. It believed that the scope of our review did not include all of the contracts it identified as direct service contracts. The department also felt that we did not correctly state the law concerning the Department of General Services' approval of direct service contracts. Finally, the department felt that we slightly overstated the intention of the Legislature that disputes be resolved within 60 days from the receipt of a complaint.

The Department of Social Services responded that it only recently became aware that the State Administrative Manual does not include all the requirements for direct service contracts. The Department of Social Services indicated that it is currently working on achieving full compliance with the reform act. However, the department feels that the type of disputes it has with the direct service contractors require significantly more than 60 days to resolve.

## INTRODUCTION

From 1980 through 1982, the Legislature enacted statutes that constitute the Direct Service Contracts Reform Act (reform act), which is contained in Sections 38000 through 38045 of the California Health and Safety Code. This reform act established requirements with which the departments within the Health and Welfare Agency (agency) must comply when they award and administer direct service contracts. Direct service contracts would include contracts wherein the department either provides a service to or receives a service from a contractor in a local assistance or subvention program. Also, the reform act states that direct service contracts shall not include contracts, grants, or subventions to other governmental agencies or units of government, nor shall they include contracts with regional centers or area agencies on aging. In addition, certain contracts entered into pursuant to specified provisions of the Welfare and Institutions Code are excluded from the definition of direct services contracts. An example of a direct service contract that would be subject to the reform act is the Department of Health Services' contract with a nonprofit organization to devise and implement an information and education project for family planning.

Before the reform act, there were no specific statutory requirements for direct service contracts. Lacking these requirements, the agency's departments and the nonprofit organizations were confused

about the state requirements for bidding and awarding direct service contracts. This confusion extended to managing and evaluating contracts also. Through the reform act, the Legislature intended to ensure that, before awarding direct service contracts to nonprofit organizations, the departments provide these organizations with the appropriate information to enable them to faithfully execute the contracts and meet the audit standards that are established by the departments.

The reform act requires the departments within the agency to identify each program for which they award more than five direct service contracts worth a total of more than \$250,000 per year. For each of the programs identified, the departments must follow certain procedures during the bidding and awarding process for direct service contracts. Additionally, according to the reform act, the departments must obtain the Department of General Services' approval on all direct service contracts unless the contracts are exempt for reasons specified in the State Administrative Manual or some other statutory authority. Furthermore, the reform act requires the nonprofit organizations entering into direct service contracts to have financial and compliance audits. Finally, the reform act assigns the departments responsibility for developing an informal grievance procedure for any disputes that arise between the departments and nonprofit organizations. According to Section 38050(b), disputes should be resolved within 60 days from the receipt of a complaint.

In 1982, the Legislature enacted Sections 38050 through 38065 of the Health and Safety Code, in addition to the reform act that established a formal appeal process for all private, nonprofit organizations seeking resolution of any dispute arising out of a direct service contract with the agency or its departments. The Office of Administrative Hearings (OAH) in the Department of General Services is the appeal authority for the formal appeal process.

#### SCOPE AND METHODOLOGY

The purpose of this audit was to review the contract-reform, audit, and appeals processes for direct service contracts with nonprofit organizations as set forth in the reform act and other related provisions at the departments within the agency. Although the departments can have direct service contracts with both for-profit and nonprofit organizations, we reviewed direct service contracts only with nonprofit organizations. Thus all references to direct service contractors in this report are to nonprofit organizations.

Our review assessed compliance with the reform act by three departments within the agency during fiscal year 1985-86 through fiscal year 1987-88 and the OAH's administration of the formal appeal process for direct service contractors. According to survey data received from the 11 departments within the agency, 10 of these departments entered into direct service contracts with nonprofit organizations during

fiscal year 1987-88. Because the Department of Aging, the Department of Health Services, and the Department of Social Services had the largest number of these contracts in fiscal year 1987-88, we reviewed these three departments to assess their compliance with the reform act.

To determine compliance with the reform act at the three departments within our review, we first had to identify the departments' programs or verify their identification of the programs for which they awarded direct service contracts during fiscal year 1985-86 through fiscal year 1987-88. Once the programs were identified, we interviewed department personnel and reviewed contract language, requests for proposals, and other documentation for selected programs to determine whether the departments had followed the procedures required by the reform act during the process of bidding and awarding direct service contracts.

As a part of our review of the three departments' compliance with the reform act, we determined whether the departments were fulfilling their responsibility of evaluating the contractors. Specifically, we sought evidence that the departments had confirmed that the direct service contractors had the required audits conducted. To accomplish this, we interviewed department personnel, reviewed audit logs and files, and sent questionnaires to selected direct service contractors.

To determine whether the departments are resolving disputes within 60 days from the receipt of complaints, we reviewed the three departments' informal grievance procedures for resolving disputes with direct service contractors. This entailed interviewing department personnel, reviewing any documented procedures, and testing selected disputes for resolution within 60 days.

To determine whether the OAH is following its established procedures for resolving disputes between the departments within the agency and direct service contractors, we reviewed the appeal files at the OAH. The three departments we reviewed did not have any disputes that went through the formal appeal process at the OAH. The Department of Rehabilitation, however, had nine such disputes with direct service contractors during the three fiscal years of our review. We found that for these nine cases, the OAH is following its established procedures and is complying with the California Health and Safety Code, so we performed no further testing.

## AUDIT RESULTS

### **THE DEPARTMENTS WE REVIEWED WITHIN THE HEALTH AND WELFARE AGENCY ARE NOT COMPLYING WITH THE DIRECT SERVICE CONTRACT REFORMS**

The departments we reviewed within the Health and Welfare Agency (agency) have done little to comply with the Direct Service Contracts Reform Act (reform act). For example, we found that these departments are not identifying the programs for which they award direct service contracts. Because the reform act requires specific controls for these programs, if the departments do not identify them, the departments may not establish all the required controls over direct service contracts. We also found that the departments are not always complying with the procedures required during the bidding and awarding process for direct service contracts. Most of these procedures are designed to more fully inform the nonprofit organizations about this process. Therefore, when the departments do not comply with the procedures, nonprofit organizations may not be aware of all the funding opportunities available through direct service contracts, all the requirements they must satisfy to submit a successful bid, or the basis on which their bid or their contract performance will be evaluated. Furthermore, the departments are not ensuring that the nonprofit organizations that contract with the State through direct service contracts (direct service contractors) have the required independent financial and compliance audits, and not all direct service contractors are having these audits conducted. Finally, the departments are not

meeting the goal of resolving disputes with direct service contractors within 60 days. This may result in the direct service contractors continuing to violate the contract provisions. Also, when disputes are not resolved promptly, the direct service contractors and the departments may incur increased costs while attempting to resolve the audit fundings.

DEPARTMENTS ARE NOT IDENTIFYING  
THE PROGRAMS FOR WHICH THEY  
AWARD DIRECT SERVICE CONTRACTS

Section 38030 of the California Health and Safety Code requires departments within the agency to identify the program for which each department awards more than five direct service contracts worth a total of more than \$250,000 per year. For these programs, the departments must apply the specific controls identified in Sections 38031 through 38035 of the California Health and Safety Code.

All three departments we reviewed within the agency are not identifying the programs for which they award direct service contracts as required in Section 38030 of the California Health and Safety Code. Specifically, the departments do not have listings of the programs for which they have awarded more than five contracts totaling over \$250,000 per year. This code requires specific controls over these programs. Thus, if the departments do not identify the programs as required, they may not know to which programs they must apply the specific controls.

As described further in this report, we found that these controls are not in place for all the necessary programs at the three departments we reviewed.

Based on interviews with department personnel and a review of budget documents, contract files, or program descriptions, we found that the three departments we reviewed had a total of 28 programs during fiscal year 1985-86 through fiscal year 1987-88 that they should have identified as programs for which they awarded direct service contracts in accordance with Section 38030 of the California Health and Safety Code. We selected 18 of these programs for our testing of the specific controls mentioned above. Table 1 shows the 18 programs we selected for testing at the three departments.

TABLE 1

**SCHEDULE OF THE PROGRAMS WITH  
DIRECT SERVICE CONTRACTS  
SELECTED FOR TESTING**

<u>Department</u>	<u>Programs Selected For Testing</u>
Aging	Alzheimers Day/Resource Center Program Brown Bag Program Foster Grandparent Program Health Insurance Counseling and Advocacy Program Linkages Program
Health Services	AIDS Program Family Planning Program Farmworker Health Program Indian Health Program Maternal Child Health Services Block Grant Program Primary Care Clinics Program Public Health Subvention Program Rural Health Program Special Supplemental Food Program for Women, Infants, and Children
Social Services	Child Abuse Prevention Program Deaf Access Assistance Program Maternity Care Program Refugee and Entrant Assistance-State Administered Programs

Departments Are Not Complying  
With Contract Bidding and  
Awarding Procedures

As explained above, Sections 38031 through 38035 of the California Health and Safety Code require that, for each program identified according to Section 38030, the departments within the

agency must apply specific controls over direct service contracts. Under these controls, each department must perform certain procedures during the process of bidding and awarding contracts. These procedures include the following:

- Development of a public annual calendar that identifies target dates for the requests for proposals (RFPs), contract bid deadlines, contract award announcements, contract approvals, and contract evaluations;
- Development and maintenance of one distribution list for all RFPs. The list should explain how additions can be made to the list, and it should contain any affirmative action policies pertinent to the program's contracting practices;
- Inclusion of specific elements in the RFPs, such as the quantitative as well as qualitative measures that the department will use to evaluate the contractor's performance and the specific criteria, a description of the methodology, and a timetable that the department will follow when reviewing and approving bids; and
- Identification in writing of any conditions for advance or interim payments.

In addition to these procedures, Section 38012 of the California Health and Safety Code requires that the Department of General Services (DGS) review and approve contracts for services. Unless a contract is exempt by a provision of the State Administrative Manual or some other statutory authority, state departments must obtain the DGS' approval of direct service contracts.

The three departments we reviewed within the agency do not always comply with the required procedures during the process for bidding and awarding direct service contracts. The three departments used RFPs in 9 of the 18 programs we reviewed. The Department of Aging used RFPs in 4 programs, the Department of Health Services used RFPs in 2 programs, and the Department of Social Services used RFPs in 3 programs. However, we found that the Department of Aging did not identify all the target dates for the contract bidding and awarding process in all 4 of the programs for which it used RFPs. Additionally, for all 9 of the programs in which the departments used RFPs, the departments did not develop single distribution lists containing all the required information, nor did they include all the specific elements required in the RFPs.

Regardless of whether they used RFPs, two of the departments we reviewed did not always obtain the DGS' approval when necessary. Specifically, the Department of Aging did not obtain the DGS' approval for the contracts in all 5 of the programs we reviewed, yet the

contracts for these programs were not exempt from the DGS' approval by any statutes or other provisions. The contracts for 2 of the 9 programs we reviewed at the Department of Health Services were exempt from the DGS' approval. However, this department did not obtain the necessary approval for the contracts in 6 of the remaining 7 programs.

When the departments do not provide all the target dates or all of the information required for RFPs, the nonprofit organizations may not be aware of all the requirements they must satisfy to submit successful bids. Also, the nonprofit organizations that are awarded contracts may not know how their bids or their contract performances will be evaluated by the department. Furthermore, if the departments do not include all the required information in their RFP distribution lists, the nonprofit organizations may not be aware of all the funding opportunities available through direct service contracts.

Departments Are Not Ensuring  
That Required Audits Are Performed

Section 38041(a) of the California Health and Safety Code requires an annual independent financial and compliance audit of direct service contractors. Section 38041(b) gives the direct service contractors the responsibility for having the audits conducted, and Section 38011 gives the departments the responsibility of evaluating direct service contractors. Since the departments are responsible for

evaluating these contractors, we believe the departments are responsible for evaluating the contractors' compliance with the audit requirement.

A financial and compliance audit is a systematic review or appraisal to determine whether the financial statements of an audited organization fairly present the financial position and the results of financial operations in accordance with generally accepted accounting principles. A financial and compliance audit should also determine whether the organization has complied with laws and regulations that may have a material effect upon the financial statements.

The audits required of direct service contractors must be performed by independent auditors in accordance with generally accepted auditing standards and must be completed by the 15th day of the fifth month following the end of the contractor's fiscal year. If a direct service contractor receives less than \$25,000 per year from any state agency, the audit must be conducted at least biennially.

The three departments we reviewed within the agency do not ensure that the direct service contractors have the required independent financial and compliance audits. Specifically, the departments do not always confirm during their evaluation of the contractors that the audits have been conducted. For example, the Department of Aging, for the five programs we reviewed, did not confirm during its contractor evaluation that the nonprofit organizations had

the required audits. However, in anticipation of performing its own program audits, the department requested from the contractors in early 1988 copies of any audits completed by other auditors in three of the five programs. In this way, the department hoped to avoid duplicate work on the part of its auditors.

Of the nine programs we reviewed at the Department of Health Services, the department confirmed audits through evaluations or other methods for only four of the programs. However, for two of these four programs, the department did not perform contractor evaluations annually. The third department we reviewed, the Department of Social Services, confirmed that, during all three fiscal years of our review, the direct service contractors had audits conducted for only two of the four programs we reviewed. For another one of the four programs we reviewed, the Department of Social Services began confirming that the audits were conducted for the fiscal year 1987-88 audits.

By not confirming that the direct service contractors have had the required audits conducted, the departments cannot be assured that the direct service contractors are complying with the audit requirements for direct service contracts. During our review, we found that not all of the direct service contractors are complying with these audit requirements. For example, for the 80 nonprofit organizations we tested at the Department of Aging, the department's records showed that only 71 of the 147 audits required during the three fiscal years of our review had been confirmed by the department. Based on responses to

questionnaires we sent to the direct service contractors, we found that at least an additional 47 of the 147 required audits were actually performed, but at least 11 of the audits had not been performed during the three fiscal years of our review.

In addition to not always having audits conducted, we found that the direct service contractors do not always have audits completed by the time specified in the California Health and Safety Code. For example, we reviewed 155 of the audit reports at the Department of Health Services that were performed for direct service contractors. However, 75 of these audits were not completed by the 15th day of the fifth month following the end of the direct service contractor's fiscal year.

Finally, we found that the audits do not always include the required reviews to determine whether the direct service contractor has complied with the laws and regulations that may have a material effect upon the contractor's financial statements. For example, for the 155 audits we reviewed at the Department of Health Services that were conducted for direct service contractors, we found that at least 32 did not have these required compliance reviews.

Departments Are Not Meeting the Goal of Resolving Disputes Within 60 Days

The California Health and Safety Code, Section 38050(b), states that, in a contractual relationship between the departments within the agency and private, nonprofit organizations, the disputing parties should set a goal of no more than 60 days from receipt of a complaint to resolution for disputes settled through an informal process.

The three departments we reviewed within the Health and Welfare Agency do not resolve disputes with direct service contractors within 60 days. The Department of Aging had only one dispute with a direct service contractor that went through its informal grievance procedures, but it took 92 days after receipt of the complaint to resolve the dispute. For 10 of the 11 disputes we selected and tested that went through the Department of Health Services' informal grievance procedures, the disputing parties took between 70 and 347 days to resolve the disputes after receiving the complaint. At the Department of Social Services, 2 of the 7 disputes we selected were still unresolved 1,456 and 1,509 days after the receipt of the two complaints. By not resolving the disputes with direct service contractors within 60 days, the direct service contractors may continue to violate contract provisions. Additionally, when disputes are not resolved promptly, the costs incurred by both the direct service contractors and the department to resolve the disputes may increase.

Departments' Reasons for Noncompliance With the Reform Act

We asked the three departments we reviewed why they did not comply with all the requirements of the reform act. The Department of Aging stated that it did not consider any of its contracts to be direct service contracts based on its interpretation of an attorney general opinion. However, based on criteria provided in the legislative counsel's opinion in the appendix, we concluded that the Department of Aging does, in fact, have direct service contracts.

The Department of Social Services stated that it followed the contracting requirements in the State Administrative Manual but that it was not aware until recently that this manual did not include all the requirements for direct service contracts.

At the time of our exit conference, the Department of Health Services chose not to provide us with a reason for its noncompliance with the reform act.

CONCLUSION

The departments that we reviewed within the Health and Welfare Agency have done little to comply with the Direct Service Contracts Reform Act. Specifically, we found that the three departments we reviewed are not identifying the programs for

which they award more than five direct service contracts totaling over \$250,000 per year. In addition, the departments do not always comply with the procedures required during the process of bidding and awarding direct service contracts. Furthermore, the departments are not ensuring that the direct service contractors have the required independent financial and compliance audits. Finally, the departments are not meeting the goal of resolving disputes with direct service contractors within 60 days.

The Department of Aging stated that it did not comply with the reform act because it did not consider any of its contracts to be direct service contracts, although a legislative counsel's opinion refutes this. The Department of Social Services stated that it was not aware that the contracting requirements in the State Administrative Manual did not include all the requirements for direct service contracts. At the time of our exit conference, the Department of Health Services chose not to provide a reason for its noncompliance.

#### RECOMMENDATIONS

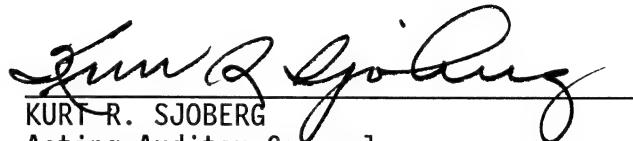
The Health and Welfare Agency should inform its departments of the requirements of the Direct Service Contracts Reform Act. It should then ensure that all of its departments are

complying with the reform act. Specifically, the agency should ensure that its departments do the following:

- Identify the programs for which they award more than five direct service contracts totaling over \$250,000 per year;
- Follow all procedures required during the bidding and awarding process for direct service contracts;
- Ensure that the required financial and compliance audits of the direct service contractors are conducted; and
- Resolve disputes with nonprofit organizations within 60 days.

We conducted this review under the authority vested in the auditor general by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



KURT R. SJOBERG  
Acting Auditor General

Date: June 30, 1989

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Sacramento, California

June 2, 1989

Mr. Kurt R. Sjoberg  
Acting Auditor General  
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## Direct Service Contracts - #9770

Dear Mr. Sjoberg:

You have submitted five contracts between departments in the Health and Welfare Agency and various private entities and have asked whether these contracts are "direct services contracts" subject to approval by the Department of General Services.

Division 25 (commencing with Section 38000) of the Health and Safety Code,<sup>1</sup> the Direct Service Contract Reform Act (hereafter "the act"), contains provisions regarding the authority to enter into these contracts, the approval process, the contract process, audit requirements, and the reform process relating to direct service contracts.

The legislative history of the act indicates that prior to its enactment, direct service contracts were negotiated and approved according to the State Administrative Manual; the provisions of which were written with administrative and purchasing contracts in mind (see Committee Report on A.B. 3069, as amended April 15, 1980, Assembly Committee on Health, 1979-80 Regular Session, page 2). The Department of Finance and the Department of General Services were required to review these contracts, but in practice, this procedure caused delays due primarily to the fact that these departments were not limited in the kinds of questions they could raise when reviewing these

<sup>1</sup> All statutory references are to the Health and Safety Code unless otherwise indicated.

contracts (see Committee Report, supra). According to this same committee report, A.B. 3069 was intended to streamline the direct service contract review process in order to alleviate funding problems that contract agencies have when their contracts with the state are not promptly approved by the state.<sup>2</sup>

Subdivision (b) of Section 38020 defines direct service contracts as follows:

"38020. \* \* \*

"(b) As used in this act "direct service contract" means a contract for services contained in local assistance or subvention programs, or both."

Section 38010 excludes contracts entered into pursuant to Chapter 7 (commencing with Section 14000) or Chapter 8 (commencing with Section 14200) of Part 3 of Division 9 of the Welfare and Institutions Code. These chapters include provisions regarding contracts entered into by the State Department of Health Services and various entities regarding certain health care programs and prepaid health plans. Section 38030 excludes contracts, grants, or subventions to other governmental agencies or units of government and contracts with regional centers or area agencies on aging.

Therefore, to be a direct service contract, a contract must meet three requirements. First, the contract must be for services. Second, the contract must be contained in local assistance or subvention programs, or both. Third, the contract must not come within one of the specific exclusions contained in either Section 38010 or 38030.

Section 38012 provides as follows:

"38012. The Department of General Services shall review and approve contracts in accordance with the provisions of Article 4 of Chapter 2 (commencing with Section 10290) of Part 2 of Division 2 of the Public Contract Code."

Section 10295 of the Public Contract Code states as follows:

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<sup>2</sup> Assembly Bill No. 3069 was enacted as Chapter 990 of the Statutes of 1980.

"10295. All contracts entered into by any state agency for (a) the hiring or purchase of equipment, supplies, materials, or elementary school textbooks, (b) services, whether or not the services involve the furnishing or use of equipment, materials or supplies or are performed by an independent contractor, (c) the construction, alteration, improvement, repair or maintenance of property, real or personal, or (d) the performance of work or services by the state agency for or in cooperation with any person, or public body, are void unless and until approved by the department. Every such contract shall be transmitted with all papers, estimates, and recommendations concerning it to the department and, if approved by the department, shall be effective from the date of the approval. This section shall apply to any state agency which by general or specific statute is expressly or impliedly authorized to enter into transactions referred to herein.

\* \* \*" (Emphasis added.)

Thus, with exceptions not relevant here, a contract for services entered into by a state agency must be approved by the Department of General Services or it is void.

The Department of General Services has established guidelines in the State Administrative Manual (hereafter "S.A.M.") with regard to contracts which are exempt from approval by the department (see Sec. 10351, P.C.C.). Section 1206 of S.A.M. explicitly exempts from approval certain categories of contracts as well as contracts with dollar amounts under specified limits. The section states that contracts can also be exempted from approval by the department by letter specifically exempting an agency from submitting certain classes of contracts or interagency agreements as is consistent with proper administrative controls and the best interests of the state. Direct service contracts are a category of contracts that may be exempted pursuant to this procedure. According to Section 1206, exemption approval will be based on a preaudit to verify that an agency has established policies, procedures, and management systems to maintain adequately controlled delegated contract programs and to comply with provisions of the law and regulations. In no event however, is a contract in excess of \$50,000 exempted from Department of General Services approval.

In addition to the above methods of exemption, a contract for services may be exempt from Department of General Services approval pursuant to statute. For example, subdivision (b) of Section 16366.7 of the Government Code provides that departmental service contracts utilizing federal block grant funds

shall be exempt from approval by the Department of Finance and the Department of General Services prior to their execution. These contracts are, however, subject to other specified fiscal controls and procedures.

By definition, a direct service contract is a contract for services subject to approval by the Department of General Services. Consequently, unless the contract is exempted by letter from the Department of General Services pursuant to the specified procedure in Section 1206 of S.A.M., or the contract is statutorily exempted from the approval requirement, a direct service contract must be approved by the Department of General Services.

We turn now to a consideration of the five contracts in question.

(a) Contract No. 87-91791 between the State Department of Health Services and the California Nurses Association

This contract required the contractor, the California Nurses Association, to conduct an acquired immune deficiency syndrome (AIDS) program to decrease morbidity/mortality of the disease in high-risk groups utilizing prescribed methods. The contract is labeled local assistance in the "program/category" and is funded from Category (b) of Item 4260-111-001 of the Budget Act of 1987 (Ch. 135, Stats. 1987), a local assistance item. The contract was made with a private, nonprofit organization, not a governmental agency or unit of government, nor a regional center or area agency on aging. Additionally, it was not entered into pursuant to specified sections of the Welfare and Institutions Code.

Thus, this contract required the contractor to perform some service, it is a contract for services contained in local assistance programs, and it does not come within the specified exclusions for direct service contracts contained in Sections 38010 and 38030. Accordingly, we think this contract is a direct service contract.

As a general rule, all direct service contracts are required to be approved by the Department of General Services, unless they are statutorily exempted or are specifically exempted by the Department of General Services. Absent any facts to indicate that this contract was subject to an exemption, Department of General Services approval was required. In fact, this contract indicates that it did receive department approval on September 25, 1987.

(b) Contract No. 87-91588 between the State Department of Health Services and Planned Parenthood Association of Santa Clara County, Inc.

This contract required the contractor to provide comprehensive family planning services to persons who voluntarily request these services and are certified as eligible according to procedures established by the state, and to provide information and education services. The contract is labeled local assistance in the "program/category" and is funded under Item 4260-111-001 of the Budget Act of 1987 (Ch. 135, Stats. 1987), a local assistance item, the same item as provided funding for contract (a). The contract was made with a private, nonprofit organization, not a governmental agency or unit of government, nor a regional center or area agency on aging. Additionally, it was not entered into pursuant to specified sections of the Welfare and Institutions Code.

Thus, this contract required the contractor to perform some service, it is a contract for services contained in local assistance programs, and it does not come within the specified exclusions for direct service contracts contained in Sections 38010 and 38030. Accordingly, we think this contract is a direct service contract.

As a general rule, all direct service contracts are required to be approved by the Department of General Services, unless they are statutorily exempted or are specifically exempted by the Department of General Services. Absent any facts to indicate that this contract was subject to an exemption, Department of General Services approval was required. In fact, this contract indicates that it did receive department approval on July 24, 1987.

(c) Contract No. 87-91301 between the State Department of Health Services and San Diego American Indian Health Center

This contract required the contractor to make available a medical, dental, and outreach program to Native American Indians pursuant to Section 1182.1 which requires the State Department of Health Services to contract with voluntary nonprofit organizations in connection with the development of local health programs for American Indians and their families. The contract is labeled local assistance in the "program/category" and was funded from Category (d) of Item 4260-111-001 of the Budget Act of 1987 (Ch. 135, Stats. 1987), a local assistance item. This is the same budget item referred to above in connection with contracts (a) and (b). The contract was made with a private, nonprofit organization, not a governmental agency or unit of government, nor

a regional center or area agency on aging. Additionally, it was not entered into pursuant to specified sections of the Welfare and Institutions Code.

Thus, this contract required the contractor to perform some service, it is a contract for services contained in local assistance programs, and it does not come within the specified exclusions for direct service contracts contained in Sections 38010 and 38030. Accordingly, we think this contract is a direct service contract.

As a general rule, all direct service contracts are required to be approved by the Department of General Services, unless they are statutorily exempted or are specifically exempted by the Department of General Services. This contract, however, states that it is exempt from Department of General Services approval per Section 1206 of S.A.M. As discussed above, a department may obtain a letter exemption from the Department of General Services for certain types of contracts including direct services contracts. However, since this contract was for an amount in excess of \$50,000 (\$115,511), Section 1206 of S.A.M. did not apply. Thus, it is our opinion that Department of General Services approval should have been obtained.

(d) Contract No. 87-91175 between the State Department of Health Services and California Rural Indian Health Board, Inc.

This contract requires the contractor to provide perinatal training and technical assistance to carry out the statutory directive of Section 301.5 which authorizes grants, contracts, or advance of funds to provide services directed toward reducing infant mortality and improving the health of mothers and children. The contract is labeled local assistance in the "program/category" and is funded from Category (c) of Item 4260-111-001 of the Budget Act of 1987 (Ch. 135, Stats. 1987), a local assistance item. This is the same budget item referred to above in connection with contracts (a), (b), and (c). The contract was made with a private, nonprofit organization, not a governmental agency or unit of government, nor a regional center or area agency on aging. Additionally, it was not entered into pursuant to specified sections of the Welfare and Institutions Code.

Thus, this contract required the contractor to perform some service, it is a contract for services contained in local assistance programs, and it does not come within the specified exclusions for direct service contracts contained in Sections 38010 and 38030. Accordingly, we think this contract is a direct service contract.

As a general rule, all direct service contracts are required to be approved by the Department of General Services, unless they are statutorily exempted or are specifically exempted by the Department of General Services. That contract states that it is exempt from Department of General Services approval per Chapter 1343 of the Statutes of 1982. That chapter enacted Section 16366.7 of the Government Code, discussed above, which provides that contracts utilizing federal block grant funds shall be exempt from approval by the Department of Finance and the Department of General Services.

Although the contract states it is funded from both the General Fund and from federal MCH Block #13.994, subject to passage of the 1987 Budget Act, as stated earlier, the contract also identifies the exact funding source as Category (c) of Item 4260-111-001 of the Budget Act of 1987. There are no federal funds, block grants or otherwise, appropriated by Item 4260-111-001 (compare Item 4260-101-001). Therefore, it would appear that Section 16366.7 of the Government Code cannot apply to the contract. Accordingly, absent any facts which would demonstrate the contract was otherwise exempt, we think Department of General Services approval was required.

(e) Contract No. L-8788-02 between the Department of Aging and Community Care Management Corporation

This contract requires the contractor to provide institutionalization prevention services to functionally impaired adults and the frail elderly pursuant to Chapter 4.7 (commencing with Section 9390) of Division 8.5 of the Welfare and Institutions Code.<sup>3</sup> Although the contract is not labeled local assistance in the "program/category" (it is listed as 40.60 Linkages), Item 4170-101-001 of the Budget Act of 1987 (Ch. 135, Stats. 1987) the funding source, is a local assistance item. The contract was made with a private, nonprofit organization, not a governmental agency or unit of government, nor a regional center or area agency on aging. Additionally, it was not entered into pursuant to specified sections of the Welfare and Institutions Code.

Thus, this contract required the contractor to perform some service, it is a contract for services contained in local assistance programs, and it does not come within the specified exclusions for direct service contracts contained in Sections 38010 and 38030. Accordingly, we think this contract is a direct service contract.

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<sup>3</sup> Hereafter Chapter 4.7.

As a general rule, all direct service contracts are required to be approved by the Department of General Services, unless they are statutorily exempted or are specifically exempted by the Department of General Services. This contract states that it is a grant, not subject to review by the Department of General Services. You have informed us that the basis of the California Department of Aging's position that approval is not required by the Department of General Services is an opinion written by the Attorney General (63 Ops. Cal. Atty. Gen. 295).

In that opinion, the issue was whether California Department of Aging grant awards with respect to certain titles of the federal Comprehensive Older Americans Act Amendments of 1978 were contracts within the scope of Section 14780 of the Government Code (now Section 10295 of the Public Contract Code), and therefore, needed to be submitted to the Department of General Services for approval.

The Attorney General opined that these grant awards were not contracts and thus Department of General Services' approval was not required. The Attorney General's rationale for this conclusion was that the California Department of Aging was merely a conduit for these funds; it received no direct benefit in the form of services but only provided guidance and administrative assistance. Moreover, the grant was not made to carry out a statutory duty of the California Department of Aging.

There are major differences between the grant documents examined by the Attorney General and the contract here at issue. First, in the former situation, the statutory authority for the awarding of funds was predicated entirely on federal law: the Comprehensive Older Americans Act Amendments of 1978. However, in the present case, the award was made to carry out the statutory duty of the California Department of Aging as required by Chapter 4.7. Second, in the former situation, the funding source was made up entirely of federal moneys. But, in the present case, it is unclear from an examination of this budget item whether funds for this particular contract were derived entirely from a federal source.

Although differences exist between the grant documents examined by the Attorney General and the contract here at issue, more significant is the fact that the Attorney General's opinion was written prior to the enactment of the Direct Service Contract Reform Act which defined the elements of a direct service contract and codified the authority of the Department of General Services to approve these contracts. As discussed above, we think that this contract meets the definition of a direct service contract. Consequently, since we are aware of no facts which constitute an exemption to the requirement of Department of General Service's

approval for direct service contracts,<sup>4</sup> it is our opinion that this contract was subject to approval by the Department of General Services.

Very truly yours,

Bion M. Gregory  
Legislative Counsel

*Debra J. Zidich*  
By  
Debra J. Zidich *(LJ, JB)*  
Deputy Legislative Counsel

DJZ:di

cc: Honorable Elihu M. Harris, Chairman  
Joint Legislative Audit Committee

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<sup>4</sup> By way of contrast, Section 18953.5 of the Welfare and Institutions Code, enacted as Chapter 1638 of the Statutes of 1984, during the same legislative session as Chapter 4.7, provides that the Office of Child Abuse Prevention may fund various programs by means of grants rather than contracts and these grants shall not be subject to the review specified in Section 10295 of the Public Contract Code. No such specific statutory exemption was contained in Chapter 4.7.

## DEPARTMENT OF AGING

1600 K STREET  
SACRAMENTO, CA 95814  
TDD Only (916) 323-8913



(916) 322-5290

June 21, 1989

Kurt R. Sjoberg  
Acting Auditor General  
Office of the Auditor General  
660 J Street, Room 300  
Sacramento, CA 95814

Dear Mr. Sjoberg:

Mr. Clifford Allenby, Secretary, Health and Welfare Agency, has asked me to respond to your draft report (F-859) entitled "The Departments We Reviewed Within the Health and Welfare Agency Are Not Complying With the Direct Service Contract Reforms." After reviewing your draft, I feel that you have captured the essence of our comments in the sections labeled "Departments' Reasons for Noncompliance With the Reform Act," page 18 of the draft, and "Conclusion," page 19 of the draft.

As you have indicated, the Department of Aging stated that it did not consider any of its contracts to be direct service contracts based on its interpretation of an Attorney General's opinion. If this is not the case, as suggested in the Legislative Counsel's letter to you, then you may be assured that this Department will implement any needed procedures or actions necessary to comply with Sections 38000 through 38045 of the Health and Safety Code (Direct Services Contracts Reform Act).

After your audit staff had their exit conference with members of the Department staff, I was glad to hear that many of the areas that came into question, although not in complete compliance, were to a degree being carried out.

Even though we operated under the interpretation that we did not come under the direct service contract provisions, all of our grants were prepared under the requirements specified in the State Administrative Manual for contracts. I feel that with slight adjustments in our contracts processing, this Department will be well within the requirements mandated by Section 38000.

As we are audited annually by your office because of our federal funds, we have much contact with your staff. The team assigned to perform this audit continued to reflect the cordialness of the other members of your staff who have worked with our Department. Please thank them for their professionalism.

Sincerely,

A handwritten signature in cursive ink that reads "Alice Gonzales".  
ALICE GONZALES  
Director

cc: Mr. Clifford Allenby

## DEPARTMENT OF HEALTH SERVICES

714/744 P STREET  
P.O. BOX 942732  
SACRAMENTO, CA 94234-7320  
(916) 445-1248



JUN 26 1989

Mr. Kurt R. Sjoberg  
Acting Auditor General  
Office of the Auditor General  
660 J Street, Suite 300  
Sacramento, CA 95814

Dear Mr. Sjoberg:

Mr. Clifford L. Allenby, Secretary of the Health and Welfare Agency, has asked me to respond to your report entitled "The Departments We Reviewed Within the Health and Welfare Agency Are Not Complying With the Direct Service Contract Reforms". The Department of Health Services, as one of the Departments reviewed, would like to disagree with the general overall finding of this report that we have done "...little to comply with the Direct Service Contracts Reform Act" (pg. 18).

While it is difficult to argue that the Department has impeccably followed the requirements of the Direct Service Contract Reform Act (DSCRA), we believe we have made a serious effort to comply. In the specific areas covered by the report, it should be noted that:

- o The Department did attempt to identify programs covered by the DSCRA shortly after its enactment in 1980. However, the act itself does not clearly identify which contracts should be considered as direct services contracts. Partly, as a result of the confusion in the law in this area the Department has not repeated that identification on an annual basis as the Auditor General suggests it should. It should also be noted that the statute does not clearly require such annual program identification.
- o Many, if not most, of the requirements for contract bidding and awarding procedures were followed by our programs. The only DSCRA requirement not met by all Department programs was related to the failure to develop single distribution lists for RFPs (p. 12). The Department has made efforts to apply the other reform act requirements for contracts that could clearly be identified as involving "direct services".

Further, it is the intent of the Department to refine its contract listings to specifically identify those program areas with more than five direct services contracts with an aggregate value in excess of \$250,000.

- o The Department has modified the several hundred contracts it issues annually to require that an independent audit be conducted where appropriate. The draft audit notes that not all Department programs insure compliance with this contract requirement. Understandably, we have placed higher priority on ensuring that contracts are properly completed and services properly delivered in accordance with other contract requirements.
- o The Department has developed and fully implemented procedures to provide for the resolution of direct service contract disputes. This has included the development of not only specific contract provisions related to disputes, but also regulations. The Department recently completed many months of effort to set out in regulations uniform direct service contract appeal procedures. These regulations, 22 California Code of Regulations, Section 20201 et seq., not only define "direct services contracts", but also set up time limits for dispute resolution which will help the Department and its contractors meet the suggested goal of resolving disputes within 60 days. Section 22 CCR Section 20204. <sup>(1)</sup>

The Department also wishes to point out some general areas of concerns it has with this report. These include:

- o The draft audit report notes that the contracts covered by the DSCRA "...include contracts wherein the Department either provides a service to or receives a service from a contractor in a local assistance or subvention program" (p. 1). For purposes of clarity, it should be noted that the Department has interpreted the DSCRA to apply to some contracts wherein it is neither providing a service nor receiving a service from the contractor. Some Department programs, including local assistance and subvention programs, have been directed by the Legislature to provide funds to community based agencies for services they deliver to the public. The Department has considered such arrangements to be direct service contracts even though they do not involve the provision of services to or from the Department. See discussion at 63 Opinions of the Attorney General 290 at 294 (1980). <sup>(2)</sup>
- o The draft audit report states that according to the DSCRA, the Department must obtain the Department of General Services approval on all direct services contracts unless the contracts are exempt for reasons specified in the State Administrative Manual, the California Government Code, or other statutes (p. 2, see also pp. 12-13). This is not a correct statement of law. In fact, Health and Safety Code Section 38012 provides that "the Department of General Services shall review and approve contracts in accordance with the provisions of Article 4 of Chapter 2 (commencing with Section 10290) of Part 2 of

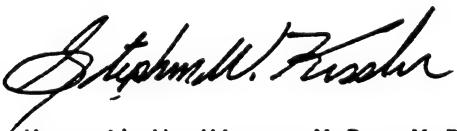
Division 2 of the Public Contract Code". The Attorney General has repeatedly opined that the identical Government Code sections which preceded these Public Contract Code provisions require Department of General Services review and approval of only certain types of contracts: 63 Opinions of the Attorney General 290 (1980); 58 Opinions of the Attorney General 586 (1975). Presumably, the Legislature intended to incorporate only these limited requirements into the DSCRA since it clearly required only Department of General Services review and approval of direct service contracts "...in accordance the Public Contract Code".<sup>3</sup>

Following the Attorney General's interpretation, the Department has submitted contracts to the Department of General Services for review and approval only where the Public Contract Code requires it to do so. The Department's legal staff has consistently concluded that not all contracts covered by the DSCRA require such review and approval.

- o The draft audit report states that "according to Section 38050 (b), the Legislature intends that disputes be resolved within 60 days from the receipt of a complaint" (p. 2 see also P. 17). This is slightly overstated. Section 38050 (b) provides "the intent between the disputing parties is to resolve their controversy through informal dispute process. The parties should set a goal of no more than 60 days from receipt of a complaint to resolution" (emphasis added).<sup>4</sup>

We hope that these comments will be taken into consideration prior to the release of a final report. If you should have any questions, please feel free to contact Bob Tousignant, Assistant Chief Counsel, at 2-9407.

Sincerely,

  
for Kenneth W. Kizer, M.D., M.P.H.  
Director

DEPARTMENT OF SOCIAL SERVICES

744 P Street, Sacramento, CA 95814



June 26, 1989

Kurt R. Sjoberg  
Acting Auditor General  
Office of the Auditor General  
600 J Street, Suite 300  
Sacramento, CA 95814

Dear Mr. Sjoberg:

OFFICE OF THE AUDITOR GENERAL'S (OAG) DRAFT AUDIT REPORT ENTITLED "THE DEPARTMENTS WE REVIEWED WITHIN THE HEALTH AND WELFARE AGENCY ARE NOT COMPLYING WITH THE DIRECT SERVICE CONTRACT REFORMS (F-859)."

Mr. Clifford Allenby, Secretary, Health and Welfare Agency (H&WA) has asked me to respond to your June 19, 1989 letter transmitting and requesting comments in response to the above named draft audit report. Following are the Department of Social Services' (DSS) responses to findings and recommendations which pertain to the DSS.

1. OAG Finding

"All three departments we reviewed within the agency are not identifying the programs for which they award direct service contracts as required in Section 38030 of the California Health and Safety Code. Specifically, the departments do not have listings of the programs for which they have awarded more than five contracts totaling over \$250,000 per year." (Page 8)

OAG Recommendation

The departments should identify the programs for which they award more than five direct service contracts totaling over \$250,000 per year. (Page 20)

DSS Response

Although the DSS was briefed regarding initial legislative activity involving private nonprofit contracting, it was not until recently that DSS became aware that the Legislature had not charged state control agencies with the responsibility to interpret this law through the State Administrative Manual process, the process normally used to regulate state department contracting activities.

Since that time, however, DSS has sought clarification of the Health and Safety Code and is making every effort to achieve full compliance with the provisions of that Code.

2. OAG Finding

"The three departments we reviewed within the agency do not always comply with the required procedures during the process for bidding and awarding direct service contracts. The three departments used RFPs in 9 of the 18 programs we reviewed...the Department of Social Services used RFPs in 3 (out of 4) programs...Additionally, for all 9 of the programs in which the departments used RFPs, the departments did not develop single distribution lists containing all the required information, nor did they include all the specific elements required in the RFPs." (Page 12)

OAG Recommendation

The departments should follow all procedures required during the bidding and awarding process for direct service contracts. (Page 20)

DSS Response

The DSS' bidding documents are currently in substantial compliance with provisions of the Health and Safety Code. Contracts Bureau is working with program management, however, to strengthen future bid documents to ensure full compliance with the provisions of law.

Currently, access to distribution lists and copies of past RFP's are available to the bidding public at any time. In addition, the Office of Small and Minority Business in July 1989 will begin offering all departments training in the development of affirmative action contract statements. The DSS will send a representative to that training and thereafter prepare an affirmative action contract statement to comply with the bid list requirements of the Health and Safety Code.

3. OAG Finding

"The three departments we reviewed within the agency do not ensure that the direct service contractors have the required independent financial and compliance audits.

Specifically, the departments do not always confirm during their evaluation of the contractors that the audits have been conducted...The third department we reviewed, the Department of Social Services, confirmed that, during all three fiscal years of our review, the direct service contractors had audits conducted for only two of the four programs we reviewed. For another one of the four programs we reviewed, the Department of Social Services began confirming that the audits were conducted for the fiscal year 1987-88 audits." (Pages 14 and 15)

OAG Recommendation

The departments should ensure that the required financial and compliance audits are conducted of the direct service contractors. (Page 20)

DSS Response

During the audit period, audits of the kind required by the Health and Safety Code were being done for the majority of nonprofit agencies contracting with DSS. Lack of full awareness of this Health and Safety Code requirement, however, resulted in some cases in noncompliance. The DSS' Contracts Bureau is currently working with all affected programs to ensure full compliance with the Code.

4.

OAG Finding

"The three departments we reviewed within the Health and Welfare Agency do not resolve disputes with direct service contractors within 60 days...At the Department of Social Services, 2 of the 7 disputes we selected were still unresolved 1,456 and 1,509 days after the receipt of the two complaints. By not resolving the disputes with direct service contractors within 60 days, as intended by the Legislature, the direct service contractors may continue to violate contract provisions. Additionally, when disputes are not resolved promptly, the costs incurred by both the direct service contractors and the department to resolve the disputes may increase." (Page 17)

OAG Recommendation

The departments should resolve disputes with nonprofit organizations within 60 days as intended by the Legislature. (Page 20)

DSS Response

While Section 38050 of the California Health and Safety Code states that the disputing parties should set a goal of 60 days to resolve audit disputes, it does not mandate such a time limit. In addition, the two contracts questioned by the auditors expired prior to the time the disputed issues were raised. Therefore, there is no possibility that the contractors "may continue to violate contract provisions."

We agree that additional costs may be incurred by both the department and the contractor if disputes are not resolved promptly. However, these audits are not simply audits of financial statements. Rather, they involve questions of compliance with Federal cost principles, adequacy of documentation, or double billings (frequently involving other governmental entities). These matters are highly technical, complex and require significantly more than 60 days to resolve. The department, however, requested and received approval, during last year's budget process, to establish an Administrative Law Judge position and 1.5 Staff Counsel positions to help reduce the amount of time to resolve disputes and avoid backlogs in unresolved audit disputes.

Thank you for providing DSS this opportunity to comment on the audit prior to the finalization of your report. Should you have any questions, please feel free to contact me at (916) 445-2077 or have your staff contact Mr. Robert L. Garcia, Deputy Director, Administration at (916) 445-4622.

Sincerely,



LINDA S. McMAHON  
Director

THE OFFICE OF THE AUDITOR GENERAL'S COMMENTS  
ON THE RESPONSE BY THE  
DEPARTMENT OF HEALTH SERVICES

We are commenting on the Department of Health Services' response to our audit report to provide clarity and perspective to the response to our report. The numbers correspond to numbers we have placed in the Department of Health Services' response.

- ① We were aware that the department was drafting regulations for "direct service contract appeal procedures." However, these regulations, set forth in Title 22 of the California Code of Regulations, Section 20201 et seq., were not approved by the Office of Administrative Law until May 31, 1989. Therefore, these regulations were not in effect during the three fiscal years covered by our review.
- ② We agree that the department's contracts through which it funds community-based agencies for public services are direct service contracts because the department receives a service when a contractor administers a state or federal program. We have included these contracts within the scope of our review.
- ③ Article 4 of Chapter 2 (commencing with Section 10290) of Part 2 of Division 2 of the Public Contract Code applies to all contracts entered into by a state agency for services to be rendered to the State. In his opinion in the appendix on page 26, the legislative counsel states that "by definition, a direct service contract is a contract for services subject to approval by the Department of General Services." On page 30, the legislative counsel further states that there are major differences between the documents examined by the attorney general and the contracts we reviewed. Finally, the legislative counsel states that "more significant is the fact that the attorney general opinion was written prior to the enactment of the Direct Service Contracts Reform Act which defined the elements of a direct service contract and codified the authority of the Department of General Services to approve these contracts."

As part of the legislative counsel's opinion, the legislative counsel reviewed two of the department's contracts that were not approved by the Department of General Services. As described on pages 27-29, he found that these two contracts were direct service contracts, and as such, they required the Department of General Services' approval.

- ④ Our final report was changed to eliminate the perceived overstatement.

cc: Members of the Legislature  
Office of the Governor  
Office of the Lieutenant Governor  
State Controller  
Legislative Analyst  
Assembly Office of Research  
Senate Office of Research  
Assembly Majority/Minority Consultants  
Senate Majority/Minority Consultants  
Capitol Press Corps